Moscow Financial Weekly

For the Week Ending November 2, 2001

Treasury Attache's office, US Embassy Moscow

Highlights This Week

- GOR moves to adjust budget in response to lower oil prices
- **Weekly Focus**: **Regional Focus - Tver**

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	29.7297	0.33	5.56
Monetary Base*	R665.6 bln	-1.45	37.89
CPI	NA	0	13.9
International Reserves*	$38.8 bln	0.52	37.10
RTS Index (end of week)	203.52	2.23	43.03
Refinancing rate	25	0	0

*For week prior

Economic Developments

In response to President Putin's admonishment that lower oil prices not be allowed to undermine the GOR's solid fiscal stance, the government has proposed changes to the **2002 budget** bill that claw back some of the additional R52 billion of spending agreed during the second reading. Under this plan, R37 billion of this spending would be held back until the end of the 3rd quarter. (R15 billion cannot be held back because it represents federal payment of regional government wages.) At this point if 1) the revenues have actually been collected (a big if with Urals at $18.5/barrel vs a budget assumption of $23.5/barrel), 2) the "financial reserve" has been funded (ie. the surplus is intact) and 3) Russia has made all its debt payments, then the funds would be released. If this doesn't happen, the spending allocations to law enforcement, agriculture, and road construction would be cancelled. The Duma budget committee will start discussing proposed amendments for the third reading, including this one, on November 12.

The official **budget surplus** for Jan-Aug was reported at R174.6 billion vs. R137 billion during the same period last year. Preliminary September figures show a slight drop to R170 billion, reflecting lower oil prices. Meanwhile, the Tax Ministry reported tax collections 36% higher than targeted (16% of GDP) through September. Though the combination of additional year–end spending and lower oil prices may further reduce the year-end surplus, the GOR's fiscal position remains strong.

Revised **GDP** was R4,002 billion in 1H 2001, up by 5.1% y-o-y. This is still consistent with the official estimate of 5.5% for all of 2001.

Banking sector

Several announcements from **Sberbank:**

- Private deposits in Sberbank increased during 10 months of 2001 by R100 billion to R4400 billion. In 2000 private deposits in the bank went up by R114 billion.
- Sberbank currently has R27 billion in deposits with the CBR and over R40 billion in mandatory reserves at the CBR.
- Sberbank's 2001 profit would exceed the 2000 profit of R11.2 billion by international accounting standards (IAS) and R12.7 billion by Russian standards, but the bank did not say by how much.

In a newspaper interview **CBR** First Deputy Chairman Tatyana Paramonova said the Central Bank is going to provide equal rights to residents and non-residents in buying bank shares. At present the law allows Russian residents to buy freely up to 20-% stakes in banks, Paramonova explained, while non-residents have to get a permission to purchase even a single share. The CBR wants this norm to be reduced for Russians and raised for non-residents, thus making it same for all.

Paramonova also said that in the future the CBR would, *probably*, allow **foreign banks** to operate in Russia without being registered as a Russian legal entity (ie. as a branch). However she said that the decision can be made only after the transition to of the banking system to IAS which is slated only for 2004. She said regulatory issues related to operations of foreign banks on the Russian territory will be considered when finalizing the Joint Strategy of the GOR and the CBR for banking sector development. (The deadline for completing the work on the Strategy has been missed, apparently due to disagreements between CBR and Min Econ.)

When asked how many banks would survive the transition, Paramonova said that numerous forecasts were not based on reality since no one had made an **IAS** assessment of the Russian banking sector and the CBR itself is just trying to make such an assessment. Marina Chekurova, First Deputy Director of ARCO that after the the transition to IAS 30-40% of Russian banks would not be able to meet the CBR requirements and would eliminated. The transition would lead to numerous mergers, Chekurova said. She also promised that all regional banks currently managed by ARCO, except Bashprombank and Dalrybbank, would be sold by the end of this year.

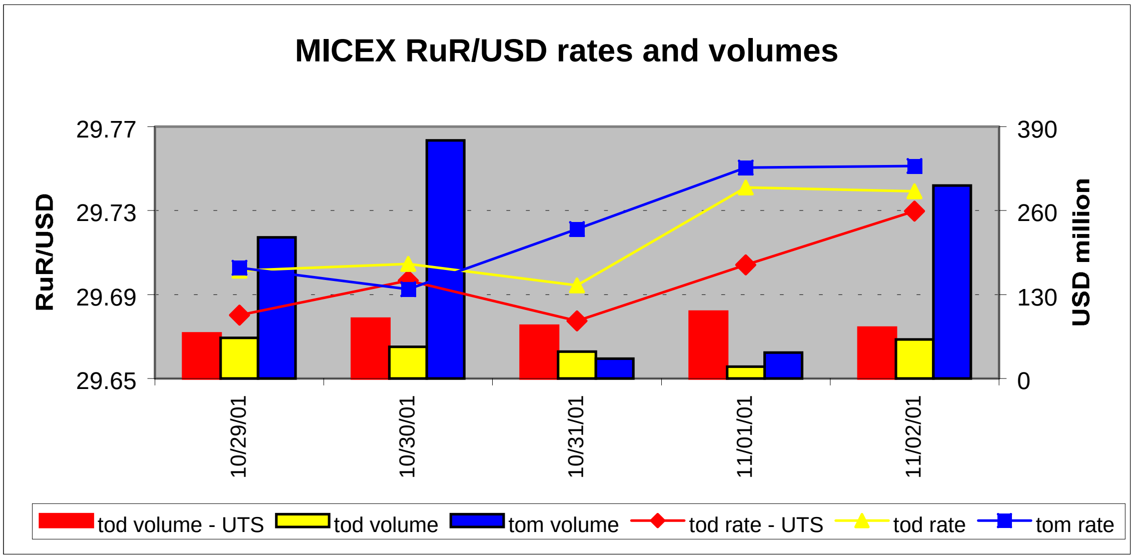
93.3% of commercial banks in the city of **Moscow** are financially stable, Konstantin Shor, head of the Moscow territorial branch of the CBR told banking conference. This implies that about 7% of banks are not sound and will have to be shut down, Shor said. He informed that currently there are 617 commercial banks registered in Moscow. Moscow banks have around R750 billion in deposits with the CBR. At the same time businesses have about R140 billion deposited in Moscow banks.

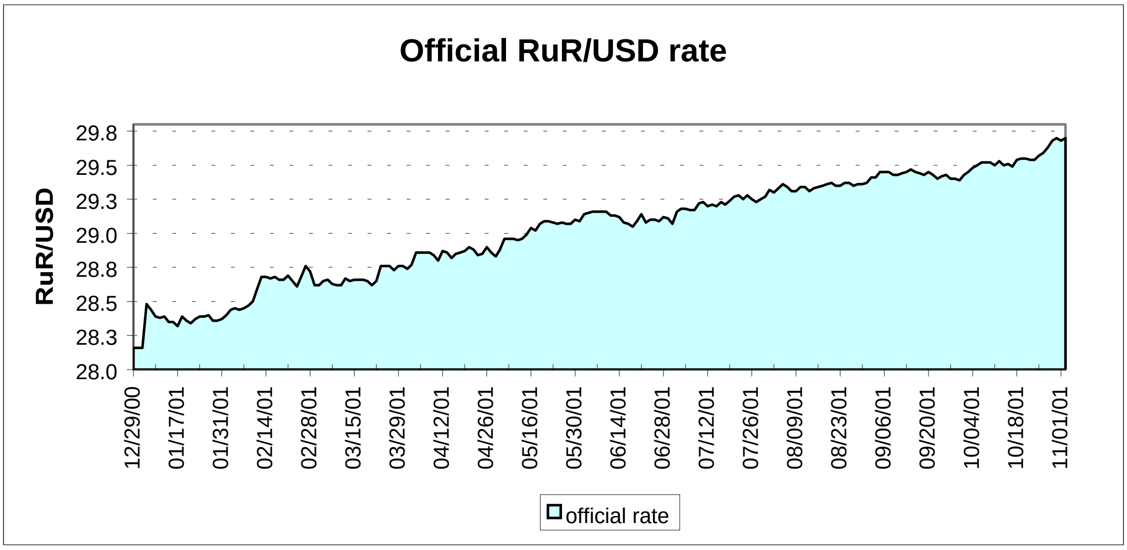
Financial markets

Forex Market

In the Monday UTS trading the ruble lost almost 5 kopeks against the dollar all at once and in the afternoon trading the CBR intervened for first time in quite a while. The next morning the ruble weakened further and again the CBR intervened trying to defend the ruble at the R29.7/$ level. In two days the CBR sold at least $500 million. On the last day of October interbank ruble loan rates surged and the ruble firmed against the dollar, but with the beginning of November resumed weakening. Demand for dollars was especially big on Friday, caused by fears of more significant devaluation due to falling oil prices. Friday afternoon the CBR intervened again, this time at the R29.74/$ level.

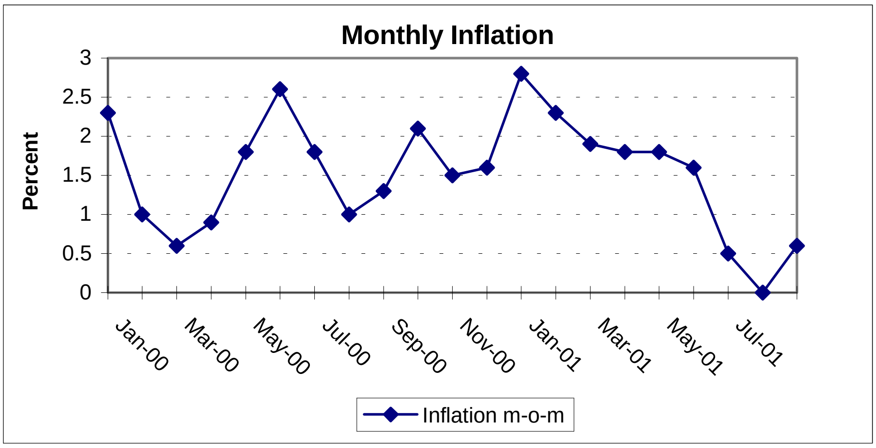
For the week the ruble weakened 0.33%, closing in the UTS on Friday at 29.7297/$. MICEX weekly trade volumes were $426 million, $232 million and $956 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively, i.e. the total MICEX volume nearly tripled from the previous week.





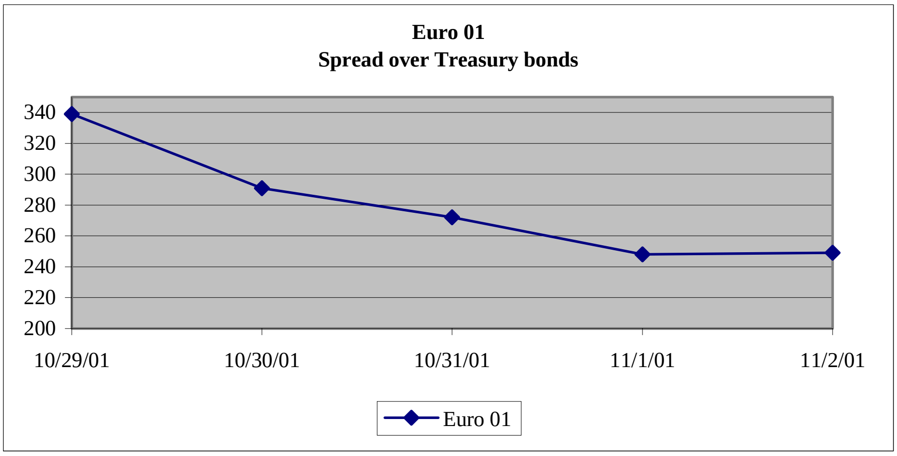
Prices

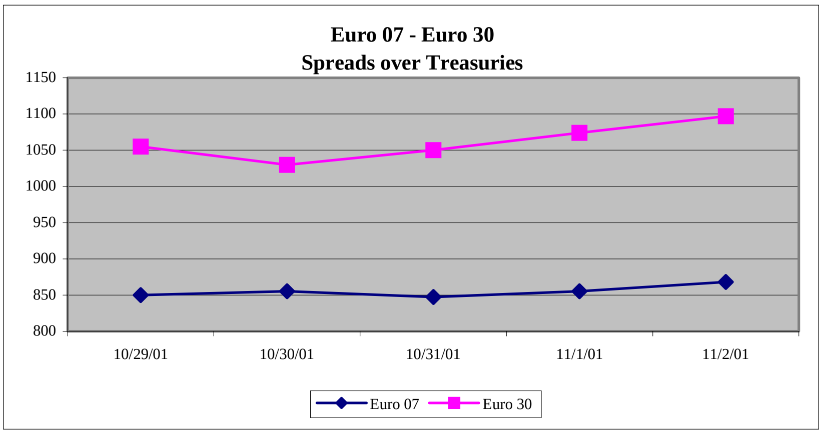
Inflation in October totaled 1.1%, lower than many expected. The main reason for the lower level appears to be the cancellation of a planned gas price increase. Private and government inflation forecasts now are in the 17.5-18%. During the month, service prices increased the most - up 1.9%. Excluding the seasonal factor of fruit and vegetable prices inflation was up by 1.3%.



Eurobonds

Last week the Russian Eurobonds again outperformed. Negative news from Argentina cooled off the market, but, spreads on Russian bonds were not affected to the full extent. Spreads of the Euro-01 kept decreasing. The issue is to be redeemed on November 27, after which players expect additional increase in Russia's sovereign ratings.

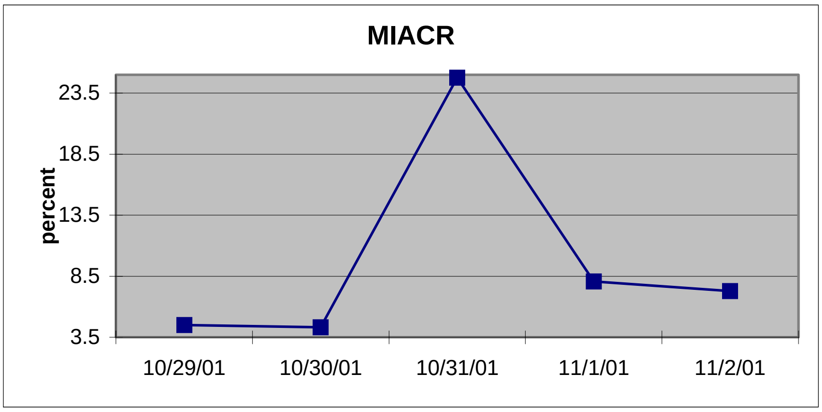




Interest/Bond Market

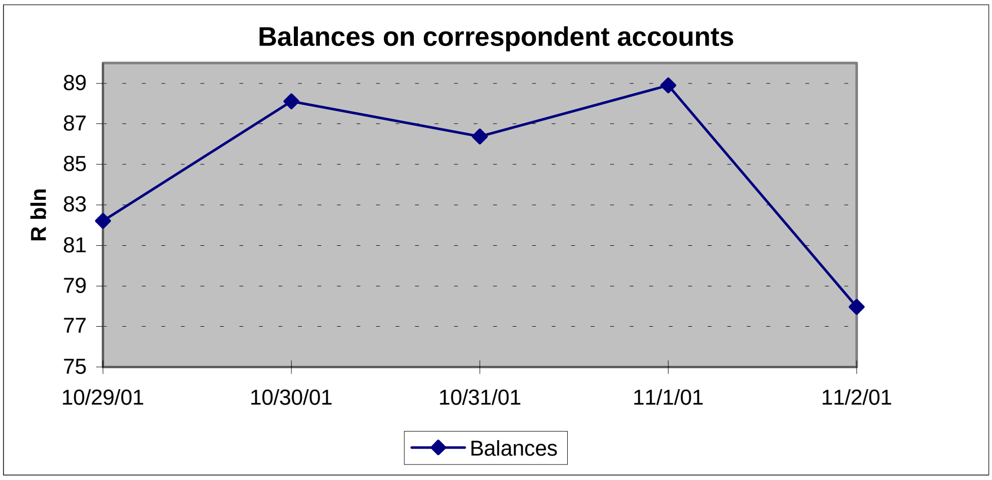
Bonds/Bills

The secondary OFZ/GKO market is more dead than alive with very low liquidity last week. On Thursday, volumes dropped to as low as R113 million. Prices however grew slightly all week. On Wednesday, the yields of all OFZ issues for the first time fell below 17% p.a.



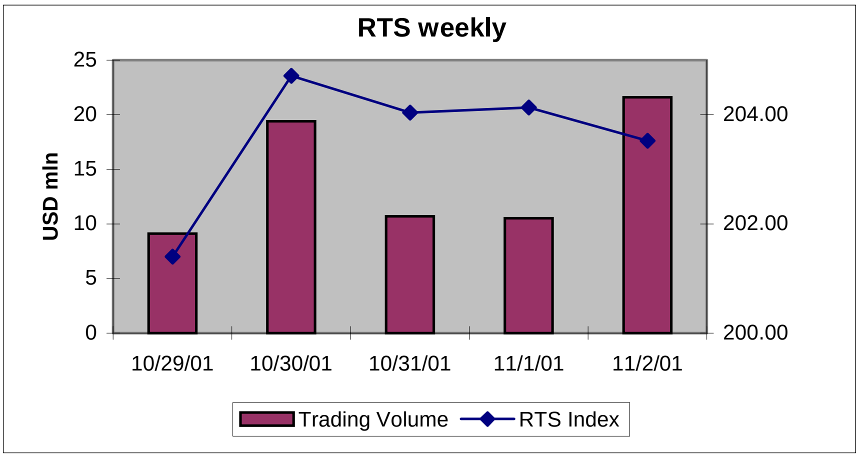
Overnight rates

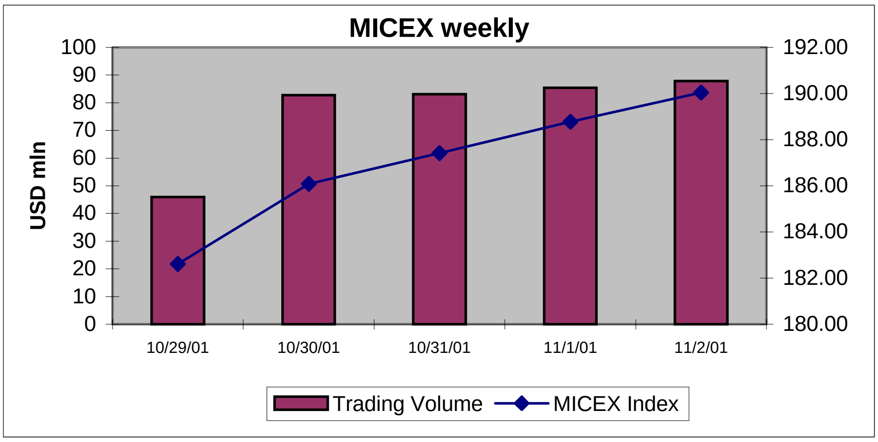
The market experienced an unusually high liquidity for the end of the month when bills are due. Balances on banks' correspondent accounts at the CBR stayed in the 80's which kept overnight interbank ruble loan rates as low as 0.5-1.5% p.a.. During the last day of the month market experienced the usual ruble shortage causing overnight rates to fluctuate in the range of 20-35% p.a. within the day.

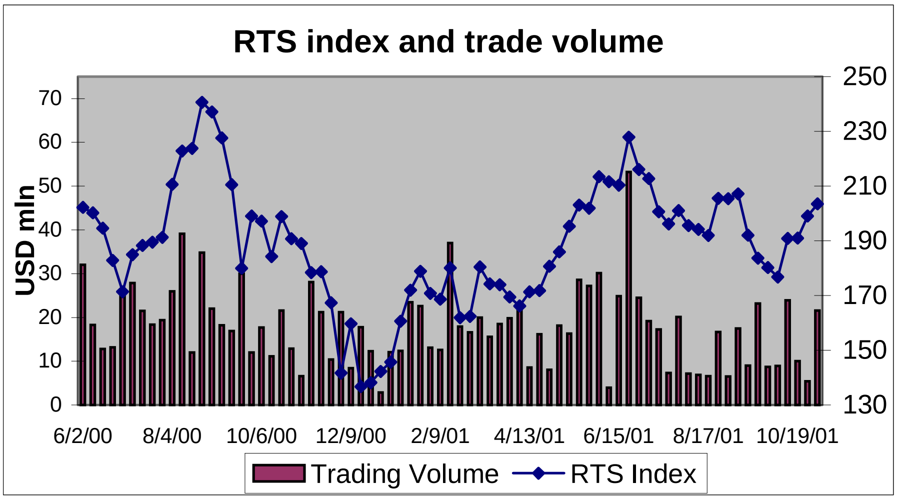


Stock Market

Last week the market saw long-waited foreign buying. Players were interested in the most liquid shares - RAO UES, Surgut, YUKOS. The market pierced the psychologically important level of 200 and said there. The RTS index almost reached the levels of the beginning of September. Again the market proved the absence of correlation with the world markets - positive domestic news (good macroeconomic indicators) as well as expectations of oil price growth on the threshold of winter were the main driving factors for the market. High ruble liquidity dragged prices up as well. The RTS index was up by 2.23% for the week in dollar terms, the forth straight week of growth.

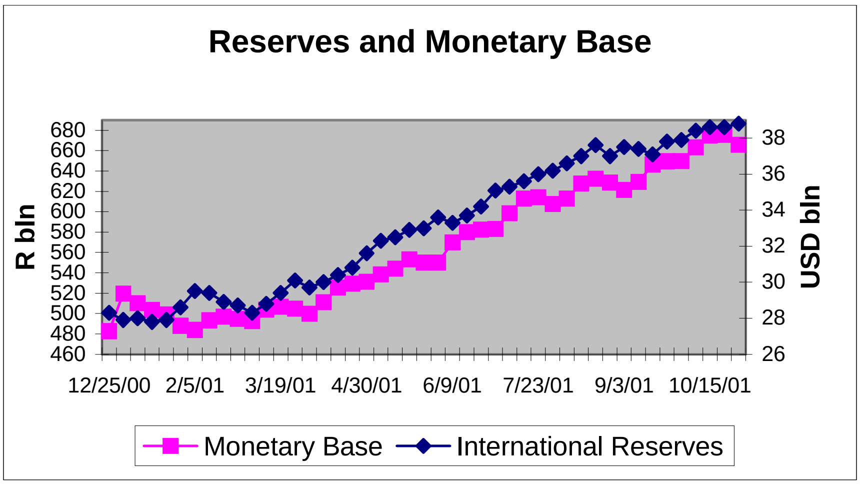






International Reserves and Monetary Base

International reserves of the Finance Ministry and Central Bank grew last week by $200 million to the new record high of $38.8 billion. The CBR Chairman Viktor Gerashenko says his aim is to reach $40 billion by the end of the year.
Base money decreased last week by R9.8 billion or 1.45%. This brought the level of monetary base back to the levels of the beginning of October.



Regional Snapshot: Tver

A theme heard a lot lately from potential Russian investors is that the place to look for opportunities is in the regions. It is here that "real" entrepreneurs are said to exist and where investors can avoid the machinations of the big oligarch controlled conglomerates. Governments and the International Financial Institutions are also taking a more regional focus, supporting regions that show signs of improving their investment environments. Still, the history of regional investment funds, including those run by the EBRD and OPIC, has been at best mixed, which raises the question of how realistic these expectations are.

To put this new regional focus in perspective, we wanted to take a look at an "average" region, representative of where the majority of Russians lives. Helping the most advanced regions will benefit the citizens of places like Samara and Leningrad Oblast. But the answer to whether Russia will see broad-based growth or rather grow islands of relative prosperity in a sea of poverty will depend on how well these more typical regions perform. This week we look at Tver Region, 160 km north of Moscow, to see what it is doing to increase investment and growth.

<u>Tver's Position in Russia</u>

Tver's population of 1.6 million people has an average per capita income of $57 per month (as of August 2001), compared to $88 per month on average for Russia (excluding Moscow) and $387 per month for Moscow, according to Goskomstat. The Tver economy, compared to others in Russia, has few strategic resources exportable to world markets. The Oblast's main natural resources are peat, limestone, brick clay, gravel and charcoal. Regional enterprises produce machines and equipment, synthetic fibers and leather, glass, timber and other goods. Industrial production in Tver represents 0.5 percent of the total for the Russian Federation in 2000. Tver has its Soviet-era military/industrial monolith: the railroad car plant produces a significant portion of Russia's railroad cars as well as specialized cars for transporting nuclear and hazardous material. Tver produces over 30 percent of the nation's flax; flax production and cattle breeding dominate its agricultural sector due to the region's poor soil. A nuclear power plant and hydroelectric plant are the largest industrial enterprises (44 percent of industrial production), and export 25 percent of their power to other regions. Tver's position on the Volga, providing access to Riga in the north and the Black Sea in the south, and a former Soviet military airport, are assets that, if developed, could turn Tver into a regional transport hub. It also has historic and natural attractions that make it a natural vacation destination for Moscovites, but tourism remains undeveloped.

As the low per capita income figures indicate, Tver has not capitalized on its geographic and its (admittedly somewhat meager) industrial advantages. The main problem, say Oblast economic development officials, is lack of capital. Investment in Tver, including foreign and domestic trade credits and government credits, amounted to only $7.9 million ($4.9 per capita) in 2000. This compares poorly with other regions that have better perceived investment environments and opportunities: Novgorod Region had investment of $49.5 million ($67 per capita), Samara had $236.2 million ($71.4), Nizhny Novgorod had $64.3 million ($17.37 per capita), and Tomsk had $25 million ($23.2).

Like most parts of Russia, Tver bounced back fairly strongly from the 1998 financial crisis and devaluation, albeit at a very low level. Industrial production was up 7% and 8% respectively in 1999 and 2000. Production in machine-building, chemicals and light industry more than doubled from 1999 to 2000 according to Oblast officials, the beneficiaries of import substitution. Unfortunately, even with considerable growth, these are still only a small part of Tver's industrial base. For the most part Tver region has stagnated even as its rival to the South has boomed. As the ruble has slowly appreciated in real terms, Tver's competitive position is eroding. Without capital and know-how coming in to boost productivity, growth is beginning to lag.

Tver's Development Plan

As one might expect, Oblast officials see their development woes as a result of Russia's economic problems or competition with Moscow (they hearken back to Tver's struggle with Moscow in the 13th century), rather than of their own making. To jump start their economy, Oblast officials are seeking strategic investors for Tver's largest firms such as its railroad car plant, light, hydroelectric power, and synthetic fibers. It is looking to develop the textile industry as a way to add value to flax and synthetic fiber production, and has requested financial support from the federal budget for this purpose. It also wants to build more tourist hotels as there are only two up to western standards. Oblast officials hope that strategic investors will build these into large industries able to export to the rest of Russia and abroad, as well as getting the companies and the region out of the vicious cycle of inter-company and budgetary debt.

All this sounds fine, if it were realistic. The focus on large projects involving existing large companies, is rather common among regional officials. To some extent this may reflect the fact that they see economic development primarily as a way to solve their fiscal problems rather than as an end in itself. The Governor of Tver considers reduction of the Oblast's dependence on federal budget transfers as the central goal of Tver's economic program. According to Oblast budget officials, the region's budget covers only about half of the money it needs for infrastructure improvements to roads, schools, and hospitals. In this sense large projects overseen by the regional government are the most reliable sources of income for the budget. Small entrepreneurs who generally resist paying taxes are less desirable. The focus on "the big hit" rather than "letting a thousand flowers bloom' is also a legacy of the Soviet system where bigger was better regardless of ROI.

Opportunities missed

Oblast officials welcomed the investment-friendly legislation coming out of Moscow to lower profit taxes, reduced bureaucratic red tape, and allowed purchase of land in cities for commercial purposes. It was hoped that as a result investment in the region would pick up substantially in 2001. Oblast officials are genuinely perplexed that it hasn't, given what they believe are profitable businesses. They seem to have little appreciation however for what kinds of conditions make a deal attractive to an investor.

Meanwhile, as they hunt for elusive strategic investors, they virtually ignore small and medium enterprises (SMEs). Oblast development officials profess to see no role for SMEs in the economic development plan, largely because they see enterprises as such a small contributor to the regional budget. Citing international experience in other transition economies that show SMEs as key to economic growth, elicits a shrug.

As a result, little attention is paid to removing burdens on new and small business. Tver has 34 regulatory/supervisory bodies involved in such licensing as electric power, heating, environmental standards, fire, health and sanitation, and other technical standards. While, these apply to all sizes of businesses, they are especially hard for SMEs to bear. Individual inspectors typically require firms to use specific contractors to fix problems at a highly inflated cost in order to get a license. There is no central place for businesses neither to go for help in the liscencing process nor to find out what is actually required. Proposals to combine regulatory agencies and streamline the process, programs that have been implemented in some regions, have bogged down in the local legislature. Protection from criminal gangs is also expensive. Companies, complain of harassment by tax authorities of the federal, oblast, and municipal level. The local brewery says it often disputes tax claims in court and wins, but the time and cost are draining.

Financing for Business Dependent on the State

Some branches of Moscow commercial banks are opening up in Tver, and officials hope that this will usher in a new source of credit to ailing industries. Besides Sberbank, officials and locals cite Bashcreditbank, an aggressive regional player, as a bank they trust with their money. The EBRD's small business program exists here, but does little business. Otherwise credit comes mostly the old fashioned way – from the government. There are some municipal budget guarantees for bank credits, and the federal budget provides some funding to Tver's light industries. There is also a fixed amount in the regional budget for paying bank interest on enterprise credits. In general these government credit program are inefficient and serve as bailouts for favored companies. In facing a severe shortage of commercial banking services, Tver is by no means unique among Russian regions. A central question in bank reform is whether better branch networks at larger banks or improved regional banks are the answer to bringing credit to outlying areas.

Conclusion

If Tver is representative of the attitude of officials in most Russian regions, it is fair to say that the idea of creating a virtuous circle, where regions compete for investment though market reforms, is still a ways away. While regions clearly are targeting outside investment, at least in Tver's case, the approach seems based more on hope than creating real market incentives. This approach leaves dormant the sector with perhaps the greatest potential, SMEs.

But clearly what the federal government has shown over the past two years is that change can come fast. Russia's regions are entering a period when policy improvements are likely to be more readily rewarded by investors. Without internationally recognized strategic resources and industries, average regions like Tver will have to work even harder to attract investors, but as Novgord has shown, it can be done. Hopefully, regions like Tver won't miss their chance.

Questions or Comments?

Please send your questions or comments on this Weekly to "ustreasu@online.ru".

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.